In the Supreme Court of the United States

OCTOBER TERM, 1924

UNITED STATES OF AMERICA AND FRANK K. Bowers, Collector of Internal Revenue, Petitioners, *v.* HENRY H. KAUFMAN, TRUSTEE IN BANKruptcy of Abraham Finkelstein, Israel Finkelstein, and Nettie Finkelstein, Individually, and as Copartners Trading as Finkelstein Brothers.	No. ——

UNITED STATES OF AMERICA AND FRANK K. Bowers, Collector of Internal Revenue, Petitioners, *v.* ALFRED C. COXE, JR., RECEIVER OF JONES and Baker, Alleged Bankrupts.	No. ——

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

The Solicitor General, on behalf of the United States of America and Frank K. Bowers, Collector of Internal Revenue for the Second District of New York, prays that a writ of certiorari issue to review

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the decree of the United States Circuit Court of Appeals for the Second Circuit entered on April 14, 1924 (R. 70) (R. 48), affirming in one opinion separate orders in bankruptcy of the District Court for the Southern District of New York in the above two cases (R. 44) (R. 22).

STATEMENT OF THE CASE

Respondent in the first case above is trustee in bankruptcy of Abraham Finkelstein, individually, and Finkelstein Brothers, a partnership, composed of Abraham Finkelstein and two others. Said partnership was engaged in business in New York City as manufacturers and importers of embroidery and dealers in cotton goods. Individual income tax return for the year 1919 was filed by Abraham Finkelstein under Sections 218 (a) and 223 of the Revenue Act of 1918 (40 Stat. 1057, Chap. 18, *infra*). The entire income shown therein was derived from the partnership business and represented salary and undistributed share of the partnership net income for 1919 (R. 23), previously reported under Section 224 of said act. The return was filed March 15, 1920, and at the same time \$3,841.10, which was one-quarter of the total tax liability of \$15,364.40, was paid. Subsequently the partnership and the partners, individually, went into bankruptcy. The balance of the tax amounting to \$11,523.30, plus statutory interest, has not been paid (R. 25), and constitutes the basis of the Government's claim in this case.

Upon examination it was found that Abraham Finkelstein had no separate individual estate. He stated that "all the property that he had in the world had been placed by him in the firm of Finkelstein Brothers" (R. 18). *It is admitted that the total income of Abraham Finkelstein upon which the tax in question is based was derived from the partnership business* and the correctness of the tax is not questioned (R. 23). The partnership assets are much in excess of the tax liability, but are not sufficient to pay all the partnership creditors in full (R. 26).

In the second case above Jones & Baker was a New York stock brokerage firm, now defunct, in which William R. Jones and Jackson B. Sells were the sole partners. On May 31, 1923, the firm, an alleged bankrupt, was placed in the hands of respondent as receiver. In July, 1923, income taxes for 1918, 1919, and 1920 were assessed against Jones (R. 13, 15) and Sells (R. 17, 19) in amounts which on November 26, 1923, were reduced by stipulation to $273,739.07 on the part of Jones (R. 10) and $5,518.41 on the part of Sells (R. 11). On November 23, four months after the assessment and three days prior to the date of said stipulation, an offer of composition in bankruptcy was made by the firm to partnership creditors (R. 6), as distinguished from the creditors of the individual partners. The tax claims are still outstanding. It is admitted that the taxes are correct (R. 10, 11). There are no separate individual estates, and partnership assets are not sufficient to pay all the partnership creditors in full (R. 3). The

same situation is presented in this case as in the Finkelstein case (R. 21, 22).

Claims for the taxes hereinbefore mentioned were filed against the respective partnership estates by Frank K. Bowers, Collector of Internal Revenue, on behalf of the United States. It was contended by the Government that said claims were payable out of the partnership assets prior to the payment of the general partnership creditors, whereas the trustee and receiver contended that the claims were only payable out of separate individual estates. Of such there were admittedly none because the individuals had put it out of their power to pay taxes by placing or leaving all their assets in the partnerships. The District Court for the Southern District of New York disallowed the claims in both cases based upon the referee's ruling in the Finkelstein case, and upon petitions for appeal the Circuit Court of Appeals in a single opinion affirmed the decrees.

QUESTION PRESENTED

Is the United States entitled to be paid out of partnership assets in bankruptcy ahead of general creditors for taxes assessed against the partners based on their distributive shares of partnership income which they have not withdrawn, and where they have placed or left all their personal assets in the partnership so that they have no individual estates out of which to pay the taxes assessed against them?

STATUTES INVOLVED

Section 218(a) of the Revenue Act of 1918 (40 Stat. 1057, Chap. 18) provides:

> That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

Section 224 of the same Act provides:

> That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

Section 3466 of the Revised Statutes of the United States provides:

> Whenever any person indebted to the United States is insolvent, or whenever the

> estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

The Bankruptcy Act of July 1, 1898 (30 Stat. 544, Chap. 541, as amended), contains in Section 5 the following subdivisions:

> (f) The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts, and the net proceeds of the individual estate of each partner to the payment of his individual debts. Should any surplus remain of the property of any partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be added to the assets of the individual partners in the proportion of their respective interests in the partnership.
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> (g) The court may permit the proof of the claim of the partnership estate against the individual estates, and vice versa, and may marshal the assets of the partnership estate

and individual estates so as to prevent preferences and secure the equitable distribution of the property of the several estates.

Section 64 (a) of the Bankruptcy Act provides as follows:

> The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality in advance of the payment of dividends to creditors, and upon filing the receipts of the proper public officers for such payment he shall be credited with the amount thereof, and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the court.

REASONS FOR GRANTING THE PETITION

1. The Court erred in holding that the United States was not entitled to be paid out of partnership assets ahead of general creditors of the partnerships.

2. The United States District Court for the District of New Jersey in the *Matter of Brezin & Schaefer* (297 Fed. 300), which presented the same question, sustained the right of the United States to collect the tax. *In re Strassburger* (23 Fed. Cas. No. 13526) and *Lewis* v. *United States* (92 U. S. 618), also support the contention of the Government.

3. The question in issue is of great public importance. Many cases involving large sums of money and presenting the same issue are now pending in various United States courts throughout the country. A review of the question by this court will set at rest

much doubt, avoid multiplicity of suits, and promote the orderly administration and settlement of insolvent and bankrupt partnership estates.

4. The ruling of the court, if allowed to stand, will have far-reaching effect. It opens the door to evasion of taxes and will seriously delay and hamper the collection of the public revenue. Large sums of money are involved.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the decree of the Circuit Court of Appeals for the Second Circuit should be granted.

James M. Beck,
Solicitor General.

ARGUMENT

I

The United States is entitled to priority in payment of taxes out of the partnership assets

The error in the instant case lies in the assumption by the Court that the Government's position is that the taxes assessed against the partners should be paid out of partnership assets the same as if assessed against the partnership. The Government's contention is quite otherwise. It is not attempting to *tax* the partnership, either directly or by implication, for taxes due from individual members. All the Government is trying to do is to *collect* such tax already assessed out of the partnership assets in which the partner had placed and left his income and other individual assets.

Section 218(a) of the Revenue Act of 1918, *supra*, provides that persons carrying on business in partnership shall be liable only in their individual capacity, but it is important to note that it also expressly provides that they shall be taxed on their shares of the partnership profits "*whether distributed or not.*" Obviously, therefore, if partners place or leave all their separate assets in the partnership the Government can only collect the tax from such partnership assets.

The fact that the partners can be taxed only in their individual capacity is not material when it comes to a question of the collection of the tax. *Collection* is an entirely different matter from *assessment*. Collection may be made from any available fund. It is immaterial that the Government can not distrain directly against the partnership. It is not limited to this remedy alone in the collection of taxes.

For example, a corporation may be dissolved and its assets distributed to its stockholders. A tax may thereafter be assessed against the corporation. Distraint against the stockholders will not lie. Nevertheless the Government can sue and require them to pay the tax to the extent of any assets received, regardless of whether such assets can be traced or whether they have been lost. (*Pierce* v. *United States*, 255 U. S. 398; *United States* v. *Boss & Peake Automobile Co.*, 285 Fed. 410.)

The analogy is close. Here the partnership received and retained the partner's property when the partner was indebted to the Government for taxes. The income to which the partner was entitled was left in the partnership. Finkelstein testified "that all the property he had in the world" he had placed in the partnership. To such extent the partnership estate has been enriched. Clearly, under the trust fund theory above mentioned, the Government is entitled to be paid out of the partnership assets ahead of the general creditors, at least to the extent that individual assets increased the

assets of the partnership. Otherwise the creditors will be enriched at the expense of the Government.

The right of the United States to be paid out of partnership assets ahead of partnership creditors is not controlled by the rule as to marshalling assets in Section 5 (f) of the Bankruptcy Act of 1898, *supra*. This Section relates to *debts* owing *creditors*, and not to *taxes* nor to the *United States*. Taxes are not debts. (*New Jersey* v. *Anderson*, 203 U. S. 483; *Meriwether* v. *Garrett*, 102 U. S. 472.) Section 5 (f) limits rights and privileges. The United States is not mentioned therein. Consequently it is not bound. It is well settled that the United States is not bound by such statutes unless expressly named. (*United States* v. *Dalles, etc., Company*, 140 U. S. 599, 632; *Gibson* v. *Chouteau*, 13 Wall. 92, 99.)

In *Lewis* v. *United States* (92 U. S. 618) a claim of the United States against an English partnership was involved. This Court passed completely over the English partnership to an associated American partnership with some, but not all, of the same partners, and held that the United States was entitled to be paid out of the individual estates of American partners ahead of the creditors of the individual partners. It was held that the rule as to marshalling assets did not apply. The decision and reasoning of the Court in that case clearly cover the converse situation with which we are here confronted.

In the case of *In re Strassburger* (23 Fed. Cas. No. 13526) the court held that the United States was

not bound by the general bankruptcy rule for marshalling assets and that it was entitled to be paid first out of partnership assets on account of the individual indebtedness to it of the partners, and that its interest in the partnership assets was not limited merely to the interest of the partners after payment of the partnership debts.

The Government contends that the correct principle for the solution of the question in the cases at bar is to be found in the *Matter of Brezin & Schaefer* (297 Fed. 300 (D. C. N. J.), decided January 25, 1924), in which similar facts and the same question were involved. There Walter Brezin and Hugo Schaefer were partners trading as Brezin & Schaefer. They were adjudicated bankrupt both individually and as partners. The United States filed a priority claim for taxes against the partnership estate for taxes assessed against the partners individually, but based on partnership income. It was objected that the claims were invalid against the partnership estate, and that there were no assets in the individual estates. The testimony showed that the partners left a considerable portion of the net profits of the partnership business undistributed. The court held that the United States could collect. It said in part (p. 304 et seq.):

> There is no dispute but that, on these various days, there were actual funds in being, voluntarily left by Brezin and Schaefer among the partnership moneys, and which, if they had been claimed by the partners as individuals—as with perfect propriety they could

have been claimed under the articles of co-partnership—would have more than sufficed to put the individuals in possession of resources out of which these taxes could have been paid and satisfied. Has the refusal or neglect of the partners to claim their individual rights from time to time, their election to leave their respective personal moneys in their business enterprise, so changed the character of those moneys, so undermined the government's claim, as practically to nullify it, and, at the same time, put in possession of the Trustee, for the benefit of partnership creditors, many thousands of dollars which, as the result of the partners' mere election, are listed as partnership funds; whereas, they were actually, at all times throughout the period herein involved, individual funds, even though unclaimed? I believe not, * * *

It should be borne in mind that this proceeding is not designed to tax the partnership for taxes due from the individuals, and therefore runs in nowise counter to the Revenue Acts of 1917 and of 1918. The taxes herein have been assessed against the individuals, and all that is now sought is an available and proper fund out of which to collect the same, as so assessed.

The government's claim for taxes is not to be classed with a creditor's claim for the payment of an ordinary debt, for "taxes are not debts, but imposts levied for the support of the government." * * *

Therefore, in my opinion, the government's claim, being in the nature of an equitable

> lien, has followed the property into the hands of the Trustee in Bankruptcy, where it awaits satisfaction. * * *
>
> Inasmuch as the undistributed profits in a partnership are to be used, so far as they extend, as the basis for the computation of an individual income tax, a partner possessed of such profits certainly has a taxable income; and such income, even in the guise of partnership funds, is available for collection, as well as computation, purposes.

The cases relied on by the Circuit Court of Appeals, such as *United States* v. *Hack* (8 Peters, 271) and *United States* v. *Evans* (25 Fed. Cas. No. 15062), are readily distinguishable from the cases at bar. They relate specifically to *debts* and *creditors*. Here we are dealing with *taxes* and the *United States*. Moreover, the *debts* in such cases did not arise out of partnership transactions, but were separate obligations of the individuals unconnected with any partnership transactions.

There is a wide difference between cases (1) where a partner incurs separate *debts* of his own unconnected with the business of the partnership of which he is a member and cases (2) where a partner incurs a liability based on a partnership transaction, or, as in the cases at bar, a *tax* liability based on partnership profits which are left in the business.

It is clear from Sections 218 (a) and 224 of the Revenue Act of 1918, *supra*, that Congress never intended that the undistributed income of a part-

nership should go free of tax. Simply because the *tax* is not assessable against a partnership as such, it by no means follows that *collection* may not be had out of partnership assets ahead of partnership creditors.

CONCLUSION

In view of the large number of cases involving the same question now pending throughout the United States, and the fact that the decision if allowed to stand will result in evasion of taxes and seriously interfere with the proper administration of the revenue laws, it is respectfully submitted that the petition for certiorari should be granted in this case.

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JULY, 1924.

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